United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

AUG 31

Honorable John Breaux
United States Senate
Washington, D.C. 20510

Dear Senator Breaux:

In accordance with the commitment contained in my August 11, 1998, letter to you, enclosed is an outline of the direction the Department of the Interior plans to take on the major issues in the final Federal oil valuation rule. The purpose of this outline is to advise you of the progress on the final rule. An identical letter has been sent to Senators Hutchison, Murkowski, Nickles, and Domenici.

After thoroughly reviewing and considering all of the comments received on the several proposed rules, including the July 16, 1998, further supplementary proposed rule, we are in the process of developing a final rulemaking consistent with the enclosed outline. I believe that you will see that we intend to make changes in response to comments from the oil and gas industry and other commenters while at the same time assure that we achieve fair market value for the public's mineral resources. This outline reflects our current state of decisions, but there may be changes as the final rule proceeds through the review process in the Department and at the Office of Management and Budget.

Recognizing that each company has individual marketing circumstances and accounting capabilities, in the final rule, we would allow companies a number of options. For example, if the lessee sells its oil at arm's length after one or more arm's-length exchanges, we would allow the lessee the option of either tracing the production to the arm's-length sale after the exchanges or paying on an index price. For the Rocky Mountain Region, lessees would use a series of benchmarks instead of the index price if they choose not to trace the production to the arm's-length sale. We would offer the same option if the lessee sells or transfers its oil to an affiliate that resells the oil under an arm's-length contract. Further, the final rule would provide that the Assistant Secretary for Land and Minerals Management or his/her delegate may issue binding valuation determinations.

I again call upon you and your colleagues to remove the rider, currently in the Interior Appropriations Bill, that would prohibit finalizing the rule for another year. As I indicated in my earlier letter, we have worked very hard over the past 3 years to accommodate the interests of all affected stakeholders in this rulemaking. We believe that we have developed the very best rulemaking possible, recognizing that the industry that pays the royalties and the Federal Government and States that receive the royalties, are simply never going to agree on certain issues. Delaying the rule for a year will not resolve these differences but rather assure continued disputes over the existing regulations and the loss of millions of dollars to Federal and State treasuries because such regulations are outdated.

As you may know, the comment period on the rulemaking is closed. Therefore, we are not accepting any comments in response to the decisions reflected in the enclosed outline.

Thank you again for your continued involvement in this issue.

Sincerely,

Bob Armstrong

Bob Armstrong
Assistant Secretary, Land and
Minerals Management

Enclosure

United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

AUG 31 1998

Honorable Kay Bailey Hutchison
United States Senate
Washington, D.C. 20510

Dear Senator Hutchison:

In accordance with the commitment contained in my August 11, 1998, letter to you, enclosed is an outline of the direction the Department of the Interior plans to take on the major issues in the final Federal oil valuation rule. The purpose of this outline is to advise you of the progress on the final rule. An identical letter has been sent to Senators Breaux, Murkowski, Nickles, and Domenici.

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United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

AUG 31 '98

Honorable Frank H. Murkowski
United States Senate
Washington, D.C. 20510

Dear Senator Murkowski:

In accordance with the commitment contained in my August 11, 1998, letter to you, enclosed is an outline of the direction the Department of the Interior plans to take on the major issues in the final Federal oil valuation rule. The purpose of this outline is to advise you of the progress on the final rule. *An identical letter has been sent to Senators Breaux, Hutchison, Nickles, and Domenici.*

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United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

AUG 31 1998

Honorable Don Nickles
United States Senate
Washington, D.C. 20510

Dear Senator Nickles:

In accordance with the commitment contained in my August 11, 1998, letter to you, enclosed is an outline of the direction the Department of the Interior plans to take on the major issues in the final Federal oil valuation rule. The purpose of this outline is to advise you of the progress on the final rule. An identical letter has been sent to Senators Breaux, Hutchison, Murkowski, and Domenici.

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Sincerely,

Bob Armstrong

Bob Armstrong
Assistant Secretary, Land and
Minerals Management

Enclosure

United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

AUG 31 1998

Honorable Pete V. Domenici
United States Senate
Washington, D.C. 20510

Dear Senator Domenici:

In accordance with the commitment contained in my August 11, 1998, letter to you, enclosed is an outline of the direction the Department of the Interior plans to take on the major issues in the final Federal oil valuation rule. The purpose of this outline is to advise you of the progress on the final rule. An identical letter has been sent to Senators Breaux, Hutchison, Murkowski, and Nickles.

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Bob Armstrong

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Assistant Secretary, Land and
Minerals Management

Enclosure

OUTLINE FOR FEDERAL OIL VALUATION FINAL RULEMAKING

Note: The following outline reflects the direction in which the Minerals Management Service (MMS) and the Department of the Interior (Department) are headed in developing a final oil rule after reviewing all of the comments received on the several proposed rulemakings, including the July 16, 1998, further supplementary proposed rulemaking. The decisions reflected in this outline are subject to modification when the draft final rule proceeds through review in the Department and the Office of Management and Budget. Because the comment period on the rulemaking is closed, we are not accepting any comments in response to the decisions reflected in this outline.

Definitions

Affiliate

We would define the term "affiliate" separately from the term "arm's length," as suggested by many commenters. The term "affiliate" will use the same criteria for determining control as the existing regulations (less than 10 percent ownership representing non-control, 10-50 percent representing a presumption of control, and greater than 50 percent representing control). Following publication of the final rule, MMS intends to develop specific guidelines for lessees to follow when attempting to rebut the presumption of control when ownership is between 10 and 50 percent.

Gross Proceeds

We would maintain the definition of the term "gross proceeds" proposed in the February 6, 1998, second supplementary proposed rule. That is, the term "gross proceeds" would include payments for marketing services which the lessee must perform at no cost to the Federal Government and for payments made to reduce or buy down the purchase price of oil to be produced in later periods.

Valuation of Oil Sold by the Lessee at Arm's Length

We would provide that value is the gross proceeds received by the lessee under an arm's-length sales contract with three exceptions, the first two of which are contained in the existing regulations:

1. The sales contract does not reflect total consideration actually transferred either directly or indirectly from the buyer to the seller.

2. The value is not reasonable due to either:

   a. Misconduct by or between the parties to the arm's-length contract; or

   b. Breach of the lessee's duty to market the oil for the mutual benefit of the lessee and the lessor. In response to comments received from industry and others about the revised language in the July 16, 1998, proposal being ambiguous, in the final rule MMS is moving in the direction of not including the July 16 language in the rule, but stating in the preamble that MMS will not second-guess a company's marketing decisions.

3. The oil is disposed of under a non-competitive call that is exercised by the purchaser.

If any one of these three exceptions applies, then the lessee must value its oil based on the method used to value oil not sold at arm's-length (Alaska North Slope (ANS) spot price in California and Alaska, benchmarks in the Rocky Mountains, and applicable spot prices for the rest of the country).

<u>Valuation of Oil Sold After Arm's-length Exchange Agreements or Sold by an Affiliate at Arm's Length</u>

If the lessee sells its oil at arm's length after one or more arm's-length exchanges, we would allow the lessee the option of valuing its production on either the sale after the exchange(s) or index prices. For the Rocky Mountain Region, lessees would use a series of benchmarks instead of index prices if they choose not to trace the production to the arm's-length sale.

Similarly, if the lessee sells or transfers its oil to an affiliate that resells the oil under an arm's-length contract, we would allow the lessee the option of valuing the production on either the gross proceeds received by the affiliate under the arm's-length resale contract, subject to the above stated exceptions for oil sold by the lessee at arm's length, or index prices. Again, for the Rocky Mountain Region, a series of prescribed benchmarks would be used instead of index prices.

The lessee could make separate elections for oil that it exchanges at arm's length and oil that it transfers to an affiliate that resells the oil. However, each of these elections must be for a 2-year period, and the lessee would value all oil in each of these categories in the same manner.

<u>Valuation of Oil Not Sold at Arm's Length</u>

For California and Alaska: ANS spot price less a location/quality differential would apply.

For the Rocky Mountain Region: (Utah, Colorado, Wyoming, Montana, North Dakota, and

South Dakota):

The first applicable of the following benchmarks would apply:

1. The highest bid under an MMS-approved tendering program in which the lessee:

    a. offers and sells at least 30 percent of the its production from both Federal and non-Federal leases in the area, and

    b. receives at least three bids for the tendered volumes from bidders who do not have their own tendering programs that cover some or all of the same area.

2. The volume-weighted average of the lessee's and its affiliate's arm's-length contract prices for the purchase or sale of oil from the field or area. The total volume purchased or sold under those contracts must exceed 50 percent of the lessee's and its affiliate's production from both Federal and non-Federal leases in the same field or area.

3. The spot price for West Texas Intermediate crude at Cushing, Oklahoma, adjusted for location and quality.

4. If all of the first three benchmarks result in an unreasonable value, the MMS Director could establish an alternative valuation method.

For the OCS and Mid-Continent (other than California, Alaska, and the six-State Rocky Mountain Region):

A market center spot price less a location/quality differential from the market center to the lease would apply.

Location/Quality Adjustments to Index Prices

If the lessee used index pricing to value its production, it would adjust the index price for location/quality differentials using:

1. A location/quality differential contained in the lessee's own arm's-length exchange agreement, or

2. An MMS-calculated location/quality differential. MMS would publish annually a series of differentials based on data MMS would collect on Form MMS-4415.

The lessee could also claim a transportation allowance when valuing oil based on either index or arm's-length gross proceeds as discussed below. Quality bank adjustments based on applicable pipeline quality bank specifications could also be taken if they did not duplicate the differentials above.

Transportation Allowances

Arm's-length transportation contracts

If the lessee or its affiliate transports its oil under an arm's-length transportation contract, the lessee could claim a transportation allowance for the actual costs incurred under that contract.

Non-arm's-length transportation contracts

If the lessee or its affiliate transports its oil under a non-arm's-length transportation contract, the lessee could claim a transportation allowance based on its reasonable, actual costs including operating and maintenance expenses, overhead, depreciation, and a return on investment using a rate of return equal to the industrial bond yield index for Standard and Poor's BBB rating. We would not allow Federal Energy Regulatory Commission tariffs as an exception to computing actual costs.

Subsea Gathering

We would include language in the preamble stating that MMS will review movement of bulk production from subsea completions to a platform on the ocean surface on a case-by-case basis to determine whether it is gathering or qualifies as transportation. Recognizing that this issue is primarily a gas issue, MMS intends to resolve it by issuing separate regulations or policy guidance.

Non-Binding Valuation Guidance

We would provide that the Assistant Secretary for Land and Minerals Management or his/her delegate may issue binding valuation determinations.